Board of Governors of the Federal Reserve System

Speech

Chairman Ben S. Bernanke
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The Housing Market and Subprime Lending

Over the past four quarters, the U.S. real gross domestic product (GDP) has increased at an average rate of about 2 percent. Growth during the first quarter of this year was held down by some factors--notably, significant declines in inventory accumulation, net exports, and federal defense spending--that seem likely to be at least partially reversed in the near term. Of course, the adjustment in the housing sector is still ongoing, and the slowdown in residential construction now appears likely to remain a drag on economic growth for somewhat longer than previously expected. Thus far, however, we have not seen major spillovers from housing onto other sectors of the economy. On average, over coming quarters, we expect the economy to advance at a moderate pace, close to or slightly below the economy's trend rate of expansion.

As expected, we have also seen a gradual ebbing of core inflation, although its level remains somewhat elevated. Despite recent increases in the prices of crude oil and gasoline, energy prices overall are below last year's peak; the rate of increase in shelter costs seems likely to slow, although the timing remains uncertain; and long-run inflation expectations, as derived from both surveys and market-based measures of inflation compensation, have remained contained. However, although core inflation seems likely to moderate gradually over time, the risks to this forecast remain to the upside. In particular, the continuing high rate of resource utilization suggests that the level of final demand may still be high relative to the underlying productive capacity of the economy.

In my brief remarks today I will focus on some recent developments in housing, including the emergence of some serious stresses in subprime mortgage markets. I will also discuss some initiatives taken or planned by the Federal Reserve to respond to the problems in subprime mortgage lending.

Developments in the Housing Market

As you know, the downturn in the housing market has been sharp. From their peaks in mid-2005, sales of existing homes have declined more than 10 percent, and sales of new homes have fallen by 30 percent. A leveling-off of sales late last year hinted at a possible stabilization of housing demand; however, once one smoothes through the monthly volatility of the data, more-recent readings indicate that demand weakened further, on net, over the first four months of this year. House prices decelerated sharply last year, following annual gains averaging 9 percent from 2000 to 2005. Prices have continued to be quite soft so far in 2007, although for the most part outright price declines have been concentrated in markets that showed especially large increases in earlier years.

Homebuilders have responded to weak sales by curtailing construction. Single-family housing starts have declined by a third since early 2006, sufficient to subtract about 1 percentage point from real GDP growth over the past four quarters. Despite the drop in homebuilding, the inventory of unsold new homes has risen to more than seven months of sales, a level well above the average observed over the past decade. Accordingly, and as reflected in the continued downward trend in permits to build single-family homes, residential construction will likely remain subdued for a time, until further progress can be made in working down the backlog of unsold new homes.

Recent developments in the subprime mortgage market add somewhat to the usual uncertainty in forecasting housing demand. Subprime mortgage borrowing nearly tripled during the housing boom years of 2004 and 2005. But decelerating house prices, higher interest rates, and slower economic growth have contributed to an increased rate of delinquency among subprime borrowers. This increase has occurred almost entirely among borrowers with adjustable-rate mortgages; delinquency rates for fixed-rate subprime mortgages have remained generally stable. Some of the increased difficulties now being experienced by subprime borrowers are likely the result of an earlier loosening of underwriting standards, as evidenced by the pronounced rise in 2006 in “early payment defaults”--defaults occurring within a few months of mortgage origination. All told, the rate of serious delinquencies for subprime mortgages with adjustable interest rates--corresponding to mortgages in the foreclosure process or with payments ninety or more days overdue--has risen to about 12 percent, roughly double the recent low seen in mid-2005.[1] The rate of serious delinquencies has also risen somewhat among some types of near-prime mortgages, although the delinquency rates in those categories remain much lower than the rate in the subprime market.

As a consequence of these developments, investors are now scrutinizing nonprime loans more carefully, and lenders in turn have tightened up their underwriting. Risk premiums on indexes of credit default swaps for subprime mortgage-backed securities (MBS) began to widen sharply late last year, especially for those on pools of mortgages originated in 2006. Credit spreads on new subprime MBS have also risen. Respondents to the Senior Loan Officer Opinion Survey in April indicated a substantial net tightening of standards for subprime mortgages.

Tighter lending standards in the subprime mortgage market--together with the possibility that the well-publicized problems in this market may dissuade potentially eligible borrowers from applying--will serve to restrain housing demand, although the magnitude of these effects is difficult to quantify. Subprime and near-prime mortgage originations rose sharply in 2004 and 2005 and likely accounted for a large share of the increase in the number of home sales over that period. However, originations of nonprime mortgages to purchase homes appear to have peaked in late 2005 and declined substantially since then, and by more (even in absolute terms) than prime mortgage originations. Thus, some part of the effect on housing demand of the retrenchment in the subprime market has likely already been felt. Moreover, indicators such as the gross issuance of new subprime and near-prime MBS suggest that the supply of nonprime mortgage credit, though reduced, has by no means evaporated.[2] That said, the tightening of terms and standards now in train may well lead to some further contraction in nonprime originations in the period ahead. We are also likely to see further increases in delinquencies and foreclosures this year and next as many subprime adjustable-rate loans face interest-rate resets.

We will follow developments in the subprime market closely. However, fundamental factors--including solid growth in incomes and relatively low mortgage rates--should ultimately support the demand for housing, and at this point, the troubles in the subprime sector seem unlikely to seriously spill over to the broader economy or the financial system.

Federal Reserve Initiatives and Possible Regulatory Actions
Whatever their effects on the broader economy, the problems in the subprime sector are causing real distress for many homeowners. To help mitigate the situation, the Federal Reserve and other federal supervisory agencies are encouraging the banks and thrift institutions that we supervise to work with borrowers who may be having trouble meeting their mortgage obligations, including identifying and contacting borrowers before they enter delinquency or foreclosure. Federal Reserve Banks around the country are cooperating with community and industry groups that work with borrowers and affected communities. We also continue to work with organizations that provide counseling about mortgage products to current and potential homeowners. Studies suggest that counseling can be effective in helping borrowers make better financial decisions.[3] In addition, we at the Federal Reserve, other regulators, and the Congress are evaluating what actions may be needed to prevent a recurrence of these problems. In deciding, we must walk a fine line: We have an obligation to prevent fraud and abusive lending; at the same time, we must tread carefully so as not to suppress responsible lending or eliminate refinancing opportunities for subprime borrowers.

Broadly speaking, financial regulators have four types of tools to protect consumers and to promote safe and sound underwriting practices: required disclosures by lenders, rules to prohibit abusive or deceptive practices, principles-based guidance with supervisory oversight, and less-formal efforts to work with industry participants to promote best practices. The Federal Reserve currently is conducting a thorough review of its policies with respect to each of these instruments.

Effective disclosures are the first line of defense against improper lending. If consumers are well informed, they are in a much better position to make decisions in their own best interest. To fulfill its responsibilities under the Truth-in-Lending Act (TILA), the Board has undertaken a full review of consumer disclosures for mortgage lending. For example, we are considering whether to require lenders to provide certain disclosures more quickly and are evaluating existing requirements concerning the advertising of mortgage products. As we did for our recently released proposed rulemaking on credit-card disclosures, we will be doing extensive consumer testing to evaluate the effectiveness of current and proposed disclosures required of all mortgage lenders. Of course, the information provided by even the best-designed disclosures can be useful only when it is well understood. Accordingly, the Federal Reserve produces a range of consumer education materials, including information to help potential borrowers understand adjustable-rate and other alternative mortgages, and we actively promote financial education by partnering with outside organizations.

However, combating bad lending practices, including deliberate fraud or abuse, may require additional measures. Under the Home Ownership Equity Protection Act (HOEPA), the Board has the responsibility to prohibit mortgage lending practices that it finds to be unfair and deceptive. In 2001, the Board banned several practices for high-cost loans, such as loan flipping--a practice characterized by frequent and repeated refinancing to generate fees for lenders. We will consider whether other specific lending practices are unfair or deceptive and should thus be prohibited under HOEPA. Next week we are holding a public hearing to gather input about potential abuses in mortgage lending. We will also continue to seek input from consumer and industry groups, the Federal Reserve's Consumer Advisory Council, our fellow regulators, and others who may have useful insights about mortgage lending practices.

We have also used, and will continue to use, supervisory guidance to help mitigate problems in nonprime lending. Last year, together with other federal banking regulators, we issued guidance concerning so-called nontraditional mortgages. We have also issued draft supervisory guidance concerning underwriting standards and disclosures for subprime mortgages. The agencies are now reviewing the many responses to the draft proposal.

The patchwork nature of enforcement authority in subprime lending poses a special challenge. For example, rules issued by the Board under HOEPA apply to all lenders but are enforced--depending on the lender--by the Federal Trade Commission, state regulators, or one of the five federal regulators of depository institutions. To achieve uniform and effective enforcement, cooperation and coordination are essential. We are committed to working closely with other federal and state regulators to ensure that the laws that protect consumers are enforced.

Together with other regulators and the Congress, we have much to do and many issues to consider. We undertake that effort with utmost seriousness because our collective success will have significant implications for the financial well-being, access to credit, and opportunities for homeownership of many of our fellow citizens.

Footnotes

1. Estimates of delinquencies are based on data from First American LoanPerformance. Return to text

2. Issuance data are from *Inside Mortgage Finance*. Return to text

3. See, for example, Abdighani Hirad and Peter M. Zorn (2001), “A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling,” and Gregory Elliehausen, E. Christopher Lundquist, and Michael E. Staten (2003), "The Impact of Credit Counseling on Subsequent Borrower Credit Usage and Payment Behavior," papers presented at “Seeds of Growth--Sustainable Community Development: What Works, What Doesn’t and Why?,” a Federal Reserve System Community Affairs Research Conference held in Washington, D.C., March 27-28, 2003. Return to text

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